



Danger Zone Lowlights From 2018

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Our [Danger Zone](#) reports aim to identify firms that, despite more sanguine indications from GAAP earnings, non-GAAP, and [other noise](#), have struggling businesses and highly overvalued stock prices.

It pays to read our Danger Zone reports. In 2018, 26 out of our 31 Danger Zone picks saw negative returns and 19 underperformed the market (S&P 500). All in, the Danger Zone stocks averaged a -12% return in 2018 versus the S&P 500's 8% decline, and outperformed as a short portfolio.

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However, the thesis does not always play out as we expect and, at times, some stocks only get more overvalued. Next week, we'll release our [best Danger Zone picks from 2018](#), but this week we're starting out the year by looking at where we went wrong and what we can learn from our worst-performing picks. These are the Danger Zone lowlights from 2018.

Lowlight 1: Nutanix (NTNX) – [published February 5](#): Up 37% vs. S&P down 5%

This pick turned against us right away. Less than a month after we put Nutanix (NTNX: \$40/share) in the Danger Zone, the company announced an earnings beat and the acquisition of cost control software maker Minjar, which sent shares up ~50% over the following two weeks.

Since that initial pop, the stock is actually down 23%. All the concerns we noted in our original piece, most notably the heavy losses and competition from tech giants such as Alphabet (GOOGL) and Hewlett Packard Enterprise (HPE), have weighed on shares. However, this decline has only partially offset the large initial gain.

Fundamentally, NTNX looks to be in much better shape now than it was a year ago. Its after-tax operating losses have been cut nearly in half, from over \$400 million to ~\$220 million. Its gross margin improved from 57% in 2017 to 67% in 2018. Revenue growth continues to slow, but it remains at a solid 36% TTM.

The high valuation and slowing growth means NTNX continues to earn our Unattractive rating, but we may have been overly pessimistic in our initial analysis. We plan to give greater consideration to the value of technology and recurring revenue streams when analyzing companies in 2019.

Lowlight 2: Regis Corporation (RGS) – [published February 20](#) – [Closed September 10](#): Up 36% vs. S&P up 6%

Regis (RGS: \$17/share) is a case where we were simply wrong. We doubted that the company's turnaround plan – which centered on converting company-owned stores to franchises – could generate enough profit growth to justify the valuation. It took us just over six months to realize that the company could hit those targets and more by executing on its turnaround plan.

Our big mistake was not understanding the importance of Regis' management change. Hugh Sawyer, who took over as CEO in 2017, committed to the turnaround plan much more aggressively than previous management, which resulted in significant margin improvement.

At the end of fiscal year 2017, franchises accounted for just 29% of Regis' total store count. By the end of 2018, that number had increased to 50%. This shift helped RGS double its NOPAT margin from 3% to 6%.

We assumed that the initial failure of the company's turnaround strategy was a reflection of the business itself, but the success of this past year shows that it was more about poor management. The recent success of the franchising initiative shows just how poor the company had been doing at running the stores themselves. The fact that only 50% of stores are franchised indicates there's considerable room for further fundamental improvement.



RGS' improving profitability, along with the significant amount of [free cash flow](#) it generates by selling its company-owned stores, upgraded the stock to Neutral in September and led us to close this position.

Lowlight 3: Zendesk, Inc. (ZEN) – [published March 5](#): Up 30% vs. S&P down 8%

This is the second-straight year that a customer service software company has been one of our Danger Zone lowlights. In March 2017, we put LivePerson (LPSN) in the Danger Zone, only for the stock to rise 65% over the remainder of the year.

Despite the stock price increase, we saw no major fundamental improvement in the business, so we doubled down on our bearish bet on the industry. Almost exactly a year later, we put Zendesk (ZEN: \$56/share) in the Danger Zone.

ZEN and LPSN share all the same problems: lagging margins, misaligned executive compensation, and inability to scale. However, just like with LPSN the year before, ZEN reported revenue growth above expectations in its first three fiscal quarters, and the market rewarded it with a higher valuation.

However, as with NTNX, ZEN has underperformed during the recent market volatility. The stock is down 23% from its peak in mid-September. In addition, ZEN's \$550 million in debt (9% of market cap) and industry-worst cash burn make the company more vulnerable to churn in the capital markets than its peers.

In a bull market, easy access to capital allowed ZEN to invest heavily to compete with the giants of the tech world. As volatility increases and capital becomes more expensive, ZEN may struggle to keep up. Nothing over the past year has changed our view that we were simply too early, rather than wrong, on ZEN, which currently earns our Unattractive rating.

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Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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